



Investment Office

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AGENDA ITEM 7b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** PacifiCare – UnitedHealth Group: Proposed Merger
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

CalPERS is a shareowner in both PacifiCare Health Systems (PHS) and UnitedHealth Group (UNH). Staff concludes that the merger is a net positive based on the economics of the proposed transaction. UNH is paying a fair price of \$80 per share for PHS, an 8 percent premium above the closing price at the time the deal was announced. In addition, the transaction is accretive to earnings for UNH in the first year of combining the two companies. UNH has a reasonably good track record for executing successful acquisitions. Staff's analysis incorporates an assessment of each company's record in the areas of corporate governance, specifically executive compensation, and implications of the transaction for the CalPERS health program.

The merger is still subject to shareowner approval and a special meeting date has not yet been established. Representatives from PHS and UNH have recently contacted CalPERS to request a meeting for purposes of discussing the proposed merger. Staff will take this meeting opportunity to address the ramifications of the proposed merger on shareowners, the effects of severance agreements as a result of the proposed change-in-control on shareowner interests, and opportunities to ensure corporate governance best practices are in place with the newly formed combined entity.

Investment Perspective

On July 6, 2005, PHS announced that it entered into a definitive agreement to be acquired by UNH. Based on a consensus 2005 EPS forecast of \$3.71 and industry median 2005 P/E of 19.91X (both from Thomson First Call), CalPERS derives a fair value of \$73.87 per share of PHS. The proposed acquisition agreement values PHS at approximately \$80.00 per share, an 8% premium above the closing price of PHS at the time that the deal was announced.

CalPERS currently owns approximately 423,100 shares (.48% of shares outstanding) of PHS valued at \$33 million and 7,245,585 shares (.59% of shares outstanding) of UNH valued at \$400 million. The Fund's significantly larger ownership interest in UNH further supports the approval of the proposed merger at a fair valuation.

The financial markets have viewed the merger favorably. Since the announcement of the merger, the share price of PHS has increased from \$72.70 to \$80.92 (an 11.3% gain) while UNH has increased from \$53.50 to \$56.88 (a gain of 6.3%). Over the same time period the US stock market has increased only 0.66%. The gains to the respective stocks equal approximately \$5 billion in increased shareowner value.

Corporate Governance Perspective

There are corporate governance issues that can be reasonably addressed when analyzing the governance structures of each independent company. Those issues include:

- Board structure: UNH has a classified board structure while PHS holds annual elections of the full board.
- Takeover Defenses: UNH does not have a poison pill while PHS has a poison pill that was not approved by shareowners. CalPERS believes poison pills should be approved by shareowners.
- Shareowner Responsiveness: Both UNH and PHS have supermajority voting requirements to amend bylaw or charter provisions. CalPERS prefers simple majority voting to amend bylaw or charter provisions.

There are executive compensation issues that can be reasonably addressed when analyzing the ramifications of the proposed merger and include:

- Cash bonuses that result from the completed merger are not tied to the on-going performance of the proposed combined entity.

- Newly granted equity vesting requirements are not linked to performance-based financial metrics of the proposed combined entity. Instead, equity grants are time-vested between two and four years. CalPERS prefers vesting periods of at least four years for a significant portion of overall grants.
- Gross-ups are paid to executives that incur excise tax liabilities resulting from the proposed merger.
- A maximum of \$345 million in reduced shareowner value could be realized from costs associated with severance, accelerated vesting of options and management retention. Staff is concerned that this is a partial offset to the shareowner value created by both companies since the announcement of the merger. Part of the total impact on shareowner value is a direct cost, with the balance being imbedded in the companies' stock prices. Staff would prefer the existence and use of a more cost efficient method that negates the specific impact of accelerated vesting of options as well as ties management incentives to the success of the merged entity. Staff is working on the development and implementation of policy related to the accelerated vesting of options, with the goal of identifying plan design features that reduce the negative impact of change-in-control on shareowner value.

Health Program Perspective

CalPERS' health program has analyzed the ramifications of the proposed merger and believes that UNH's acquisition of PHS would not pose an immediate threat to the CalPERS health program. Depending upon the future focus of the newly merged corporation, the UNH/PHS product line could present significant competition for the CalPERS health dollar among contracting agencies in California. New product lines may provide additional resources for CalPERS to access in order to meet the growing needs of rural health care and Preferred Provider competition. Therefore, the impact of this, and the recent Anthem/Wellpoint merger should be closely monitored for potential opportunities and challenges which may develop in the industry as a result of these business consolidations.

Request by Treasurer Angelides

In a letter (**Attachment 1**) dated September 15, 2005, California State Treasurer Phil Angelides urged CalPERS to contact the management of both firms to press for the removal of excessive compensation before the merger is submitted to shareowners for approval.

Next Steps

Staff has been contacted by representatives of PHS and UNH with the objective to meet with CalPERS as a shareowner and review the merits of the proposed merger before the merger is submitted to shareowners for approval. This meeting will provide CalPERS with the opportunity to address the following issues, at a minimum:

1. The expected effects of the proposed merger on corporate governance best practices including board composition, takeover defenses, and shareowner responsiveness.
2. The effects of the proposed merger on executive compensation including severance, change-in-control, and opportunities to align the interests of executive management with those of shareowners in the newly merged publicly traded entity. Staff will specifically request that representatives of both PHS and UNH address concerns raised in the September 15, 2005 letter to CalPERS from California State Treasurer Phil Angelides.

Staff will report back to the Investment Committee on the results of this meeting with representatives from PHS and UNH. Staff will provide CalPERS' shareowner vote decision in that report.

V. STRATEGIC PLAN:

This item is not a product of either the 2005-2006 Strategic or Annual Plans.

VI. RESULTS/COSTS:

Costs associated with this item include staff resources

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